Chapter 13

Overall Audit Strategy and Audit Program

■ Concept Checks

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1. The five types of tests auditors use to determine whether financial statements are fairly stated include the following:

   - Risk assessment procedures
   - Tests of controls
   - Substantive tests of transactions
   - Substantive analytical procedures
   - Tests of details of balances

   While risk assessment procedures (procedures to gain an understanding of the entity and its environment, including internal control) help the financial statement auditor obtain information to make an initial assessment of control risk, tests of controls must be performed to support an assessment of control risk that is below maximum. Because substantive tests of transactions provide evidence about whether transactions have been correctly recorded, these tests also provide evidence about the effectiveness of controls. Substantive evidence is obtained to reduce detection risk. Substantive evidence includes evidence from substantive tests of transactions, substantive analytical procedures, and tests of details of balances.

2. C represents the auditor's assessment of the effectiveness of internal control. Tests of controls at the C1 level would support a minimum level of control risk. This would require more testing of the controls than would be required at either C2 or C3. Testing controls at the C1 level allows the auditor to obtain assurance from the controls, thereby allowing for a reduction in the amount of substantive testing that must be performed to meet the level of acceptable audit assurance. It would be a good decision to obtain assurance from tests of controls at point C1 especially if the cost of substantive testing is considerably greater than tests of controls.

   C3 represents the idea that it is not cost-effective to test internal controls and all assurance must come from substantive testing. This decision is optimal if controls do not exist or are not effective, or the cost of the additional substantive testing is less than the cost of control testing.

   At point C2, the auditor performs some tests of controls and is able to reduce control risk below maximum. Point C2 would be appropriate if it is cost beneficial for the auditor to obtain assurance at a level between the two extremes mentioned above (C1 and C3).

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1. The four-step approach to designing tests of controls and substantive tests of transactions is as follows:
    1. Apply the transaction-related audit objectives to the class of transactions being tested.
    2. Identify specific control policies and procedures that should reduce control risk for each transaction-related audit objective.
    3. Develop appropriate tests of controls for each key control.
    4. Design appropriate substantive tests of transactions considering deficiencies in internal control and expected results from 3 above.

2. If performance materiality is low, and inherent risk and control risk are high, planned tests of details of balances that the auditor must perform will be high. An increase in performance materiality or a reduction of either inherent risk or control risk will lead to a reduction in the planned tests of details of balances.

■ Review Questions

13-1 Risk assessment procedures are performed to assess the risk of material misstatement in the financial statements. Risk assessment procedures include procedures performed to obtain an understanding of the entity and its environment, including internal controls. Auditors use the results of the risk assessment procedures to design and perform further audit procedures. Further audit procedures (not risk assessment procedures) provide the auditor sufficient appropriate evidence.

13-2 Tests of controls are audit procedures to test the operating effectiveness of control policies and procedures in support of a reduced assessed control risk, and provide the primary basis for the auditor's report on internal controls over financial reporting. Specific accounts affected by performing tests of controls for the acquisition and payment cycle include the following: cash, accounts payable, purchases, purchase returns and allowances, purchase discounts, manufacturing expenses, selling expenses, prepaid insurance, leasehold improvements, and various administrative expenses.

13-3 Tests of controls are audit procedures to test the operating effectiveness of control policies and procedures in support of a reduced assessed control risk. Examples include:

1. The examination of vendor invoices for indication that they have been clerically tested, compared to a receiving report and purchase order, and approved for payment.
2. Examination of employee time records for approval of overtime hours worked.
3. Examination of journal entries for proper approval.
4. Examination of approvals for the write-off of bad debts.

13-3 (continued)

Substantive tests of transactions are audit procedures testing for monetary misstatements to determine whether the six transaction-related audit objectives have been satisfied for each class of transactions. Examples are:

1. Recalculation of amounts (quantity times unit selling price) on selected sales invoices and tracing of amounts to the sales journal.
2. Examination of vendor invoices in support of amounts recorded in the acquisitions journal for purchases of inventories.
3. Recalculation of gross pay for selected entries in the payroll journal.
4. Tracing of selected customer cash receipts to the accounts receivable master file, agreeing customer names, and amounts.

13-4 A test of control audit procedure to test that approved wage rates are used to calculate employees' earnings would be to examine rate authorization forms to determine the existence of authorized signatures.

A substantive test of transactions audit procedure would be to compare a sample of rates actually paid, as indicated in the earnings record, to authorized pay rates on rate authorization forms.

13-5 The auditor resolves the problem by making assumptions about the results of the tests of controls and performing both the tests of controls and substantive tests of transactions on the basis of these assumptions. Ordinarily the auditor assumes an effective system of internal control with few or no exceptions planned. If the results of the tests of controls are as good as or better than the assumptions that were originally made, the auditor can be satisfied with the planned extent of substantive tests of transactions, unless the substantive tests of transactions themselves indicate the existence of misstatements. If the tests of controls results were not as good as the auditor assumed in designing the original tests, expanded substantive tests must be performed.

13-6 Substantive tests of transactions are performed to verify the accuracy of a client's accounting system. This is accomplished by determining whether individual transactions are correctly recorded and summarized in the journals, master files, and general ledger. Substantive tests of transactions are also concerned with *classes* of transactions, such as payroll, acquisitions, or cash receipts. Tracing amounts from a file of vouchers to the acquisitions journal is an example of a substantive test of transactions for the acquisition and payment cycle. Tests of details of balances verify the ending balance in an *individual* account (such as inventory, accounts receivable, or depreciation expense) on the financial statements. An example of a test of details of balances for the acquisition and payment cycle is to physically examine a sample of the client's fixed assets.

13-7 When the results of substantive analytical procedures are different from the auditor's expectations and thereby indicate that there may be a misstatement in the balance in accounts receivable or sales, the auditor should extend the tests to determine why the ratios are different from expectations. Confirmation of accounts receivable and cutoff tests for sales are two procedures that can be used to do this. On the other hand, if the ratios are approximately what the auditor expects, expansion in planned tests is not required. This means that the auditor can satisfy the evidence requirements in different ways and that substantive analytical procedures and confirmation are complementary when the results of the tests are both good.

13-8 The primary purpose of testing sales and cash receipts transactions is to evaluate the internal controls so that the scope of the substantive tests of the account balances may be set. If the auditor performs the tests of details of balances prior to testing internal controls, no benefit will be derived from the tests of controls. The auditor should attempt to understand the entity and its environment, including internal controls, as early as practical through the analysis of the accounting system, tests of controls, and substantive tests of transactions.

13-9

1. *Control #1 – Computer verification of the customer's credit limit*. The presence of effective general controls over software programs and master file changes can significantly reduce the auditor's testing of automated controls such as control #1. Once it is determined that control #1 is functioning properly, the auditor can focus subsequent tests on assessing whether any changes have occurred that would limit the effectiveness of the control. Such tests might include determining whether any changes have occurred to the program and whether these changes were properly authorized and tested prior to implementation. These are all tests of general controls over software programs and master file changes.

2. *Control #2 – The accounts receivable clerk matches bills of lading, sales invoices, and customer orders before recording in the sales journal.* This control is not an automated control, but is rather a manual control performed by an employee. General controls over software programs and master file changes would have little effect on the auditor's testing of control #2. If the auditor identifies control #2 as a key control in the sales and collection cycle, he or she would most likely examine a sample of the underlying documents for the accounts receivable clerk's initials and reperform the comparisons.

13-10 The following shows which types of evidence are applicable for the five types of tests (see Table 13-2 on p. 414).

TYPE OF EVIDENCE	TYPES OF TESTS
Physical examination	Tests of details of balances
Confirmation	Tests of details of balances
Inspection	All except substantive analytical procedures
Observation	Risk assessment procedures and tests of controls
Inquiries of the client	All five types
Reperformance	Tests of controls, substantive tests of transactions, and tests of details of balances
Analytical procedures	Substantive analytical procedures
Recalculation	Substantive tests of transactions and tests of details of balances

13-11 Going from most to least costly, the types of tests are:

- Tests of details of balances
- Substantive tests of transactions
- Tests of controls
- Risk assessment procedures
- Substantive analytical procedures

13-12 The audit of fixed asset additions normally involves the examination of invoices in support of the additions and possibly the physical examination of the additions. These procedures are normally performed on a test basis with a concentration on the more significant additions. If the individual responsible for recording new acquisitions is known to have inadequate training and limited experience in accounting, the sample size for the audit procedures should be expanded to include a larger sample of the additions for the year. In addition, inquiry as to what additions were made during the year may be made by the auditor of plant managers, the controller, or other operating personnel. The auditor should then search the financial records to determine that these additions were recorded as fixed assets.

Care should also be taken when the repairs and maintenance expense account is analyzed since lack of training may cause some depreciable assets to be expensed at the time of acquisition.

13-13 By identifying the best mix of tests, the auditor can accumulate sufficient appropriate evidence at minimum cost. The auditor can thereby meet the standards of the profession and still be cost effective and competitive.

13-14 The approach to designing tests of controls and substantive tests of transactions (Figure 13-4) emphasizes satisfying the transaction-related audit objectives developed in Chapters 6 and 12. Recall that these objectives focus on the proper functioning of the accounting system.

The methodology of designing tests of details of balances (Figure 13-6) emphasizes satisfying the balance-related audit objectives developed in Chapter 6. The primary focus of these objectives is on the fair presentation of account balances in the financial statements. The extent of testing depends, in part, on the results of the tests of controls and substantive tests of transactions.

13-15 It is desirable to design tests of details of balances before performing tests of controls and substantive tests of transactions to enable the auditor to determine if the overall planned evidence is the most efficient and effective in the circumstances. In order to do this, the auditor must make assumptions about the results of the tests of controls and substantive tests of transactions. Ordinarily the auditor will assume no significant misstatements or control problems in tests of controls and substantive tests of transactions unless there is reason to believe otherwise. If the auditor determines that the tests of controls and substantive tests of transactions results are different from those expected, the amount of testing of details of balances must be altered.

13-16 The eight balance-related audit objectives and related procedures are as follows:

GENERAL BALANCE-RELATED AUDIT OBJECTIVE	SPECIFIC OBJECTIVE	AUDIT PROCEDURE
Detail tie-in	Inventory on the inventory summary agrees with the physical count, the extensions are correct, and the total is correctly added and agrees with the general ledger.	Check extensions of price times quantity on a sample basis, foot the detailed inventory summary, and trace the balance to the general ledger and financial statements.
Existence	Inventory as stated in financial statements actually exists.	Trace inventory from final inventory summary to actual inventory and physically count selected items.
Completeness	Existing inventory items have been counted and included in the financial statements.	Select items from the physical inventory and trace to the client's final summary to make sure that all items are included.

13-16 (continued)

GENERAL BALANCE-RELATED AUDIT OBJECTIVE	SPECIFIC OBJECTIVE	AUDIT PROCEDURE
Accuracy	Inventory items included in the financial statements are stated at the correct amounts.	Perform price tests of inventory by examining supporting vendors' invoices for selected inventory items and reverify price times quantity.
Classification	Inventory as included in the financial statements is properly classified.	Compare the classification of inventory into raw materials, work in process, and finished goods by comparing description on physical inventory count tags with the client's final inventory listing.
Cutoff	Inventory cutoff is properly recorded at the balance sheet date.	Trace selected receiving reports several days before and after the balance sheet date to determine whether inventory purchases are recorded in the proper period and related physical inventory counts are included or excluded from inventory.
Realizable value	Inventory on the financial statements excludes unusable items.	Inquire of factory employees and management regarding obsolescence of inventory, and examine storeroom for evidence of damaged or obsolete inventory.
Rights and obligations	Inventory items in the financial statements are owned by the client.	Review contracts with suppliers and customers for the possibility of the inclusion of consigned or other non-owned inventory.

13-17 There is a direct relationship of the occurrence transaction-related audit objective to the existence balance-related audit objective if a class of transactions increases the related account balance (e.g., sales transactions increase accounts receivable).

There is a direct relationship of the occurrence transaction-related audit objective to the completeness balance-related audit objective if a class of transactions decreases the related account balance (e.g., cash receipts transactions decrease accounts receivable).

13-18 The four phases of the audit process are:

Phase I	Plan and design and audit approach
Phase II	Perform tests of controls and substantive tests of transactions
Phase III	Perform substantive analytical procedures and tests of details of balances
Phase IV	Complete the audit and issue an audit report

As indicated above, auditors perform tests of controls in Phase II.

13-19 Auditors frequently consider it desirable to perform audit tests throughout the year rather than waiting until year-end because of the CPA firm's difficulty of scheduling personnel and the client's need for timely financial statements. Due to the uneven distribution of the year-end dates of their clients, there is a shortage of personnel during certain periods of the year and excess available time at other periods. The procedures that are performed at a date prior to year-end are often dependent upon adequate internal controls and when the client will have the information available. Additionally, public company auditors must begin their testing of controls earlier in the year to ensure they are able to test a sufficient sample of controls for operating effectiveness. Some controls may only be performed monthly or quarterly. Thus, the public company auditor must begin testing early in the year so that there are a sufficient number of months or quarters to test.

Procedures that may be performed prior to the end of the year are:

1. Update fixed asset schedules.
2. Examine new loan agreements and other legal records.
3. Vouch certain transactions.
4. Analyze changes in the client's accounting systems.
5. Review minutes of board of directors' meetings.
6. If the client has effective internal control, the following procedures may be performed with minor review and updating at year-end:
   (a) Observation of physical inventories;
   (b) Confirmation of accounts receivable balances;
   (c) Confirmation and reconciliation of accounts payable balances.

■ Multiple Choice Questions From CPA Examinations

13-20 a. (2) b. (1) c. (4)

13-21 a. (3) b. (1) c. (3)

■ Multiple Choice Questions From Becker CPA Exam Review

13-22 a. (3) b. (1) c. (2)

■ Discussion Questions and Problems

13-23

a.	**b.**	**a.**	**b.**
1. T of C	Inquiry and observation	7. TD of B	Inspection
2. TD of B	Inspection	8. SAP	Analytical procedures
3. T of C	Inquiry	9. T of C	Inspection
4. TD of B	Recalculation	10. ST of T	Inspection
5. TD of B	Confirmation	11. SAP	Analytical procedures
6. T of C	Inspection		

13-24

a.	**b.**
1. ST of T	Completeness
2. T of C	Occurrence
3. T of C	Accuracy
4. ST of T	Accuracy
5. ST of T	Posting and summarization
6. T of C	Classification
7. ST of T	Accuracy
8. ST of T	Posting and summarization

13-25

a.	b.	c.	d.	e.	f.
1. Sales and Collection	Inspection	Test of control	N/A	Accuracy	N/A
2. Inventory and Warehousing	Physical Examination	Substantive	T D of B	N/A	Existence
3. Acquisition and Payment	Recalculation	Substantive	S T of T	Posting and summarization	N/A
4. Acquisition and Payment	Inspection	Test of control or Substantive	S T of T	Occurrence	N/A
5. Acquisition and Payment	Inspection	Substantive	T D of B	N/A	Cutoff
6. Sales and Collection	Inquiry	Substantive	T D of B	N/A	Realizable value
7. Inventory and Warehousing	Analytical procedure	Substantive	SA P	N/A	Realizable value
8. Capital Acquisition and Repayment	Confirmation	Substantive	T D of B	N/A	Existence Accuracy
9. Sales and Collection	Recalculation	Substantive	T D of B	N/A	Detail tie-in

13-26

a. TRANSACTION-RELATED AUDIT OBJECTIVE	b. TEST OF CONTROL PROCEDURE	c. SUBSTANTIVE TEST
1. Recorded transactions exist, recorded transactions are stated at the correct amounts, and transactions are properly classified. (Occurrence, Accuracy, and Classification)	Examine invoice packages for initials indicating that review has been performed.	Examine supporting invoices and recheck items checked by the clerk.
2. Existing acquisition transactions are recorded. (Completeness)	Account for numerical sequence of receiving reports and trace to acquisitions journal entry.	Reconcile vendor statements to accounts payable listing.
3. Existing cash disbursement transactions are recorded, recorded transactions exist, and recorded transactions are stated at the correct amounts. (Completeness, Occurrence, and Accuracy).	Observe cash handling procedures and examine bank reconciliation to determine if was prepared by an independent person.	Perform tests of bank reconciliation as of the balance sheet date.
4. Recorded transactions exist. (Occurrence)*	Examine invoices for the controller's initials.	Examine supporting invoices for same information examined by the controller.
5. Recorded transactions exist. (Occurrence)	Examine invoices for indication of check number and date.	Examine supporting invoices, purchase orders, and receiving reports containing the proper check number and date for each cash disbursement.

* The objectives satisfied depend upon what she examines. She might, for example, examine supporting documents for accuracy and even for account classification. In that event, those two objectives would be added.

13-27

(a) CONTROL ACTIVITY	(b) TRANSACTION-RELATED AUDIT OBJECTIVE(S)	(c) TEST OF CONTROL	(d) POSSIBLE MISSTATEMENT	(e) SUBSTANTIVE AUDIT PROCEDURE
1. Proper authorization	Occurrence	Examine approved purchase orders for a sample of acquisitions	Unauthorized acquisitions of goods	Examine supporting documents for appropriateness of expenditures
2. Adequate documents or records	Occurrence Completeness	Account for a numerical sequence of receiving reports	Unrecorded acquisitions exist	Confirm accounts payable, especially vendors with small or zero balances
3. Independent checks on performance	Timing	Examine vendors' invoices for indication of comparison	Cutoff misstatements	Perform search for unrecorded liabilities
4. Independent checks on performance	Classification	Examine vendors' invoices for indication of internal verification	Account classification misstatements	Compare vendors' invoices to acquisitions journal for reasonableness of account classification
5. Adequate documents or records	Occurrence	Examine supporting documents for indication of cancellation	Duplicate payment for an acquisition	Examine supporting documents for every payment to selected vendors
6. Independent checks on performance	Occurrence Accuracy	Examine vendors' invoices for indication of comparison	Invalid or unauthorized payment	Examine supporting documents for appropriateness of expenditures
7. Independent checks on performance	Accuracy	Examine vendors' invoices for indication of recalculation	A misstatement in calculation of a vendor's invoice	Recalculation of vendors' invoices
8. Proper authorization	Occurrence	Examine cancelled checks for signature	Invalid or unauthorized payment	Examine supporting documents for appropriateness of expenditures
9. Separation of duties	Occurrence	Observe check mailing procedures and inquire about normal procedures	Bookkeeper takes signed check and changes payee name	Compare payee name on cancelled check to supporting documents
10. Independent checks on performance	Posting and summarization	Examine indication of reconciliation of the master file and control account	Misstatements in master file or control account	Foot subsidiary records and compare to control account

13-28 a. Although a client may have very effective internal controls, the auditor cannot place complete reliance on them in evaluating whether the financial statements are fairly stated. This reflects the inherent limitations of internal control, and the need under auditing standards to perform certain tests of balances such as confirmation of receivables and observation of inventory.

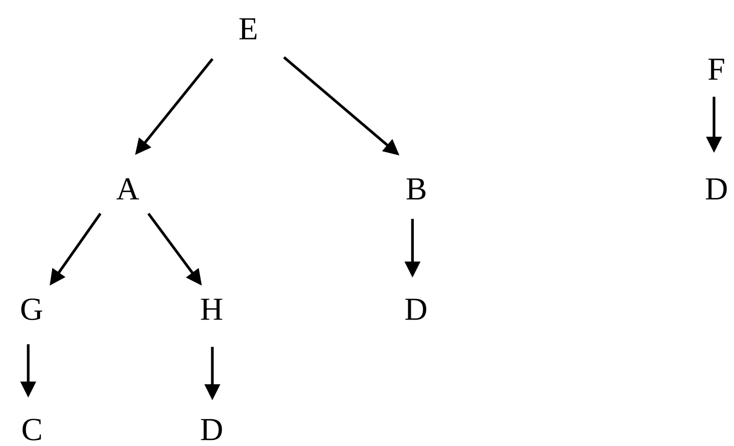
b. The auditor may decide not to place the maximum reliance on internal control if it is not cost-beneficial. The auditor may decide that it is more cost-effective to reduce reliance on controls and perform more substantive tests.

c.
1. B, C
2. C
3. A
4. B, C
5. B
6. A, B, C
7. B (assuming similar other client characteristics)
8. B, C (depending on auditor's judgment)

13-29 a. The sequence the auditor should follow is:

3. Assess control risk.
1. Determine whether it is cost effective to perform tests of controls.
4. Perform tests of controls.
2. Perform substantive tests of details of balances.

The only logical sequences for parts b. through e. are shown as follows:



Any other sequence is not cost effective or is incorrect. For example: E, A, G, C would be the sequence when there is planned reduced assessed control risk and effective results of tests of controls.

13-29 (continued)

b. The sequence is E, A, H, D. The logic was reasonable. The auditor believed the internal controls would be effective and it would be cost effective to perform tests of controls. In performing the tests of controls the auditor concluded the controls were not effective. Therefore, expanded substantive tests of details of balances were needed.

c. The sequence is E, B, G, C. The auditor concluded the internal controls may be effective, but it was not cost effective to reduce assessed control risk. The auditor should not have performed tests of controls. It would have been more cost effective to skip performing tests and instead follow the sequence E, B, D.

d. The sequence is F, A, G, C. The logic is not reasonable. When the auditor concluded the controls were not effective he or she should have gone immediately to D and performed expanded substantive tests of details of balances.

e. The sequence is F, D. The logic was reasonable. The auditor concluded that internal controls were not effective; therefore, the auditor went directly to substantive tests of details of balances and performed expanded tests.

13-30

AUDIT	PROCEDURES TO OBTAIN AN UNDERSTANDING OF INTERNAL CONTROL	TESTS OF CONTROLS	SUBSTANTIVE TESTS OF TRANSACTIONS	ANALYTICAL PROCEDURES	TESTS OF DETAILS OF BALANCES
1	E	E	S	E	S
2	M	N	S	M	E
3	E	E	M	E	S, E*

E = Extensive amount of testing.
M = Medium amount of testing.
S = Small amount of testing.
N = No testing.
S,E* = Small amount of testing for the gross balance in accounts receivable; extensive testing done for the collectibility of the accounts.

13-30 (continued)

a. For audit 1 the recommended strategy is to maximize the testing of internal controls and minimize the testing of the details of all ending balances in inventory. The most important objective would be to minimize the number of locations that need to be visited. The justification for doing this is the quality of the internal controls and the results of prior years' audits. Assuming that some of the locations have a larger portion of the ending inventory balance than other locations, the auditor can likely completely eliminate tests of physical counts of some locations and emphasize the locations with larger dollar balances. The entire strategy is oriented to minimizing the need to visit locations.

b. Acceptable audit risk for this audit should be low because of the plans to sell the business, severe underfinancing, and a first year audit. The lack of controls over accounts payable and the large number of adjusting entries in accounts payable indicate the auditor cannot consider the internal controls effective. Therefore the plan should be to do extensive tests of details of balances, probably through accounts payable confirmation and other end of year procedures. No tests of controls are recommended because of the impracticality of reduced assessed control risk. Some substantive tests of transactions and substantive analytical procedures are recommended to verify the correctness of acquisitions and to obtain information about the reasonableness of the balances.

c. The most serious concern in this audit is the evaluation of the allowance for uncollectible accounts. Given the adverse economic conditions and significant increase of loans receivable, the auditor must be greatly concerned about the adequacy of the allowance for uncollectible accounts and the possibility of uncollectible accounts being included in loans receivable. Given the internal controls, the auditor is not likely to be greatly concerned about the gross accounts receivable balance, except for accounts that need to be written off. Therefore, for the audit of gross accounts receivable there will be a greatly reduced assessed control risk and relatively minor confirmation of accounts receivable. In evaluating the allowance for uncollectible accounts, the auditor should test the controls over granting loans and following up on collections. However, given the changes in the economy, it will be necessary to do significant additional testing of the allowance for uncollectible accounts. Therefore an "S" is included for tests of details of balances for gross accounts receivable and an "E" for the tests of net realizable value.

13-31 a. 1. Audit 2
2. Audit 1
3. Audit 3

b. Besides the effectiveness of controls and the auditor's planned reliance on controls, other factors that could influence the evidence mix for the audit of acquisition and payment transactions and the accounts payable balance include:

1. Materiality of the account balance
2. Size of the populations
3. Makeup of populations
4. Initial vs. repeat engagement
5. Results of the current and previous audits
6. Existence of unusual transactions
7. Motivation of the client to misstate the financial statements
8. Degree of client integrity
9. Reliance by third parties on the audited financial statements

For example, in the first audit, the partner has apparently made the decision to emphasize tests of controls and minimize tests of details of balances. That implies effective internal controls and a low expectation of misstatement (low inherent and control risk.) In the third audit, the partner apparently has a high expectation of misstatements, and therefore believes it is necessary to do extensive substantive tests of transactions, as well as extensive tests of details of balances.

c. The audit partners could have spent time discussing the audit approach and scope with Angela prior to the beginning the audit.

13-32 a. Phase I – Procedures 7, 9, 1
Phase II – Procedure 4
Phase III – Procedures 2, 3, 5
Phase IV – Procedures 6, 8

b. The following is a time line for the audit procedures, showing the sequence of the parts of a typical audit.

	July 31		Audit Report Date
7, 9, 1, 4		2 3 5	6 8

13-32 (continued)

Parts 7, 9, and 1 are all a part of planning and are therefore done early. These are in the sequence shown in Chapter 8. As part of planning the audit, the auditor obtains an understanding of internal control and initially assesses control risk. The auditor then performs tests of controls and substantive tests of transactions and reassesses control risk.

Ideally, most substantive analytical procedures are performed after the client has prepared financial statements, but before tests of details of balances are performed. Therefore, they should be done before confirmation of accounts payable to provide information about the expectation of misstatement.

Confirmation of accounts payable should be done as early as possible after the balance sheet date to facilitate getting responses back, performing alternative procedures for nonresponses, and reconciling differences before the audit is completed.

Tests for review of subsequent events are normally the last procedures done on the engagement before the audit report date. The audit report is issued after the audit report date.

c. The time line shows that 7, 9, 1, and 4 are frequently done before the balance sheet date.

13-33 a.

Google	12/31
Boeing	12/31
Microsoft	6/30

The year-end should not impact the audit procedures performed, but it may impact the timing. Since the majority of public companies have December 31st year-ends, more procedures may need to be performed before year end to deliver the audit report on a timely basis.

b. For the fiscal year ended in 2014, the days between each company's year end and the audit report date are as follows:

Google	37 days
Boeing	43 days
Microsoft	31 days

The company's year-end, as well as the need to perform extensive procedures such as confirmation of receivables and inventory testing likely affect the number of days to issue the report.

13-33 (continued)

c. The Boeing audit had the longest period between year-end and the report date. The company has large receivables and extensive manufactured inventory. Auditors likely placed greater emphasis on tests of details of balances for this audit. However, the size of the three companies and the number of days to the issuance of the audit report suggests extensive reliance on controls and testing before year-end for all three companies.

■ Cases

13-34 a. The major deficiencies in the audit and the reasons for their occurrence are:

1. The change in the accounting system to computerize the inventory, a change in accounting personnel, and the existence of a few more errors in the tests of controls should have alerted the auditors to expand the scope of the work. It was questionable to conclude that the internal controls were effective.
2. Reduction in the scope of the inventory work based on the lack of errors last year was improper since new internal controls were in use with new personnel this year and the inventory balance was higher.
3. The new division should have been audited more thoroughly. It came to Merkle through merger and was likely to have different operating characteristics and internal controls.
4. The determination that the errors in the sample were immaterial was improper. The errors should have been projected from the sample to the population, and the projected error should have been compared to performance materiality, also considering sampling risk. The obsolescence problem uncovered in the audit should have been evaluated carefully to consider the implications on potential obsolescence of inventory.
5. Given the new personnel on the engagement, Brewer apparently failed to adequately supervise and review the work of assistants.
6. There was an apparent lack of the use of analytical procedures. A decline in sales should have warned the auditor to a potential decline in profits and obsolete inventory.

13-34 (continued)

b. Brewer should have been aware that the inventory internal controls and the personnel in that department were new, that the interim tests revealed more errors than normal, and that the inventory tests revealed more errors than normal despite the reduction in scope. In this situation, the scope of the inventory work should have been increased to reveal the magnitude of the problems encountered. In addition, because of the staff turnover on this engagement, Brewer should have devoted more of his time to supervising the work of the staff on this engagement.

c. The likelihood of Brewer losing the suit is high. The auditors appear not to have followed several of the principles in the clarified audit standards related to the auditors responsibilities and performance. Although the misstatements result from fraud, the auditors may be held responsible because apparently the audit was not conducted in accordance with auditing standards.

13-35 – Part I

a. (1) *Assess inherent risk*. This would be done under both approaches.

(2) *Obtain an understanding of internal control*. This would be done under both approaches; however, it may be more extensive where control risk is reduced below the maximum due to the knowledge gained through testing.

(3) *Perform tests of controls*. This would be done only under the "reducing control risk" approach, given that the client is a non-public entity.

(4) *Perform substantive analytical procedures*. This would be done under both approaches, although such procedures may be more extensive where control risk is reduced below the maximum.

(5) *Assess planned detection risk*. This would be done under both approaches.

b. The "reducing control risk" approach has several advantages:

1. It should result in lower overall audit cost. This will occur where the client's business activity is complex and its volume of transactions is large. In this type of situation, internal controls can provide a great deal of assurance that many of the financial statement assertions are correct, and the audit effort to test those controls can be significantly less than full-scale substantive tests of balances would require.

13-35 (continued)

2. For very large audits, it would be impossible to complete the audit on time and at an acceptable cost without relying on controls. Large clients are usually publicly held and must file their Form 10-K with the SEC within 60 days of their fiscal year end. These large companies generally have many locations, including worldwide operations. Controls must be relied upon to do these audits.
3. The more detailed investigation of controls that is required to reduce control risk, including testing, provides a better understanding of the system. This not only may provide a more concrete basis for conducting substantive tests, it creates more opportunities to make useful recommendations to the client.
4. Performance of detailed tests of transactions creates the opportunity to reveal employee defalcations that would otherwise not be discovered. In addition, employee knowledge that transactions will be examined serves as a deterrent to defalcation in the first place.

c. The primary advantage of the "substantive" approach is one of efficiency. Where clients are smaller, there is less opportunity to adequately segregate core duties, which makes it more difficult to rely on controls. Thus, the auditor focuses the audit work on the balance sheet as of the end of the client's fiscal year. Furthermore, by going into the client's office at one point in time and doing the entire audit, auditor scheduling problems are reduced and there is less disruption to the client.

13-35 – Part II

a. For this audit, .17 is the level of detection risk for tests of the inventory balance that will provide an overall audit risk of .05 assuming tests of controls and substantive analytical procedures are conducted as planned and achieve the expected results (i.e., don't indicate any misstatements exceeding performance materiality). Thus, as individual tests of details of inventory are planned, their design would be based on that level of risk of failing to reveal a greater-than-tolerable misstatement.

b.
$$PDR = \frac{.05}{1.0 \times 1.0 \times .6}$$

$$PDR = .08$$

13-35 – Part II (continued)

c. The reduction of risk for detailed tests of the inventory balance means that more reliance must be placed on those detailed tests. In this case, the degree of allowable risk is cut in half. In terms of sample size, this will result in a significant increase (the exact impact will depend on the sampling method used). It is also possible the auditor may feel less comfortable relying on substantive analytical procedures to the extent otherwise planned, and may believe some other detailed tests are appropriate.

13-35 Part III

It is not appropriate to "rework" the Audit Risk Model as proposed by the staff person. The Audit Risk Model is a planning model that is based on testing the hypothesis that the financial statements do not contain a material misstatement. If an indication of a possible misstatement is revealed by applying the model at *any stage*, the hypothesis must be rejected and the audit plan revised to assume there is a material misstatement that must be subjected to measurement. The staff person should independently evaluate whether the increase in control risk requires an increase in substantive tests. The auditor must also evaluate whether the control exceptions represent material weaknesses, which would require an adverse opinion on internal control over financial reporting.